

Assembly Bill No. 2921

CHAPTER 458

An act to amend Sections 31001, 31119, 31125, 31300, 31402, 31403, 31405, 31410, and 31411 of, and to add Sections 31001.1, 31109, 31109.1, 31406, 31407, and 31408 to, the Corporations Code, and to add Section 22063 to the Financial Code, relating to franchises, and declaring the urgency thereof, to take effect immediately.

[Approved by Governor September 10, 2004. Filed
with Secretary of State September 10, 2004.]

LEGISLATIVE COUNSEL'S DIGEST

AB 2921, Cox. Franchises.

(1) Existing law, the Franchise Investment Law, provides that it is unlawful for any person to offer or sell any franchise in this state unless the offer has been registered or exempted. Existing law makes it unlawful to solicit the agreement of a franchisee to a proposed material modification of an existing franchise without first delivering the franchisee a written disclosure. Existing law exempts from registration modifications of a franchise agreement with an existing franchisee of a franchisor if certain conditions are satisfied. Existing law makes a person who offers or sells a franchise in violation of specified provisions of the Franchise Investment Law liable to the franchisee or subfranchisor, who is authorized to sue for damages. A willful violation of the Franchise Investment Law is a crime punishable by a specified fine or imprisonment.

This bill, effective January 1, 2005, would revise the conditions that are required to be satisfied for the exemption from registration for a franchise agreement with an existing franchisee of a franchisor. The bill would exempt from registration certain offers and sales of a franchise that meet specified requirements. The bill would increase the fines authorized for certain violations of the Franchise Investment Law. The bill would make related changes.

Because a violation of the bill's requirements would be a crime, it would impose a state-mandated local program.

(2) Existing law, the California Finance Lenders Law, provides for regulation by the Department of Corporations of finance lenders engaged in the business of making consumer or commercial loans. Existing law exempts certain persons from the provisions regulating finance lenders.

The bill would exempt certain franchise loans from the California Finance Lenders Law.

(3) The California Constitution requires the state to reimburse local agencies and school districts for certain costs mandated by the state. Statutory provisions establish procedures for making that reimbursement.

This bill would provide that no reimbursement is required by this act for a specified reason.

(4) This bill would declare that it is to take effect immediately as an urgency statute.

The people of the State of California do enact as follows:

SECTION 1. Section 31001 of the Corporations Code is amended to read:

31001. The Legislature hereby finds and declares that the widespread sale of franchises is a relatively new form of business which has created numerous problems both from an investment and a business point of view in the State of California. Prior to the enactment of this division, the sale of franchises was regulated only to the limited extent to which the Corporate Securities Law of 1968 applied to those transactions. California franchisees have suffered substantial losses where the franchisor or his or her representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between franchisor and franchisee, and the prior business experience of the franchisor.

It is the intent of this law to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered. Further, it is the intent of this law to prohibit the sale of franchises where the sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled, and to protect the franchisor and franchisee by providing a better understanding of the relationship between the franchisor and franchisee with regard to their business relationship.

SEC. 2. Section 31001.1 is added to the Corporations Code, to read:

31001.1. (a) To enhance the uniform and efficient administration, and the effective enforcement, of this division, it is the intent of the Legislature that the commissioner shall maintain a risk-based process of reviewing franchise applications as described in this section.

(b) Under the risk-based review process, the commissioner shall focus on reviewing application information posing the most risk to prospective franchisees in accordance with Section 31115, with emphasis on risks associated with the franchisor's financial condition,



the franchisor's compliance record, and significant deficiencies with the franchisor's application.

(c) When reviewing franchise filings under this section, the commissioner shall concentrate on helping to prevent misappropriation, mismanagement, and misrepresentation in connection with the offer or sale of any franchise subject to this division.

(d) The commissioner shall consider guidelines, or other information developed by the North American Securities Administrators Association that are in effect, to assist in the implementation of the risk-based review process. The risk-based review procedures implemented by the commissioner shall be considered internal management criteria and guidelines within the meaning of subdivisions (d) and (e) of Section 11340.9 of the Government Code.

SEC. 3. Section 31109 is added to the Corporations Code, to read:

31109. Any offer or sale of a franchise that meets all of the following requirements shall be exempt from Chapter 2 (commencing with Section 31110):

(a) Each and every purchaser of the franchise is one of the following:

(1) Any partner, executive officer, or director of the franchisor, or any executive officer of its corporate general partner if the franchisor is a partnership, or any manager if the franchisor is a limited liability company.

(2) Any entity with total assets exceeding five million dollars (\$5,000,000) according to its most recent financial statements and not specifically formed for the purpose of acquiring the franchise offered. For purposes of this section, "entity" shall mean an organization described in Section 501(c)(3) of the Internal Revenue Code, a corporation, Massachusetts or similar business trust, limited liability company, or partnership. The financial statements referred to in this paragraph shall meet both of the following requirements:

(A) Be as of date not more than 90 days prior to the earlier of either the date on which the first prospective purchaser signs any binding franchise or other agreement with the franchisor in connection with the award of the franchise, or the date on which the franchisor receives any consideration from the first prospective purchaser in connection with the award of the franchise.

(B) Be prepared in accordance with either of the following:

(i) Generally accepted accounting principles and, if the entity has consolidated subsidiaries, on a consolidated basis.

(ii) The rules and requirements of the Securities and Exchange Commission, whether or not required by law to be prepared in accordance with those rules and requirements.



(3) Any natural person whose net worth, or joint net worth with that person's spouse, exceeds one million dollars (\$1,000,000) at the time of his or her purchase of the franchise, excluding the value of that person's personal residence, any and all retirement or pension plan accounts or benefits, home furnishings, and automobiles.

(4) Any natural person whose gross income exceeds three hundred thousand dollars (\$300,000) per year in each of the two most recent years, or whose joint gross income with that person's spouse exceeds five hundred thousand dollars (\$500,000) per year in each of those years, and who reasonably expects to reach the same income level in the current year.

(5) Any entity, in which all of the equity owners are persons or entities described in either paragraph (1), (2), (3), or (4).

(b) Each and every purchaser of the franchise has knowledge and experience in financial and business matters, either alone or with professional advisers of the purchaser who are unaffiliated with, and not directly or indirectly compensated by, the franchisor or an affiliate or selling agent of the franchisor, such that the franchisor reasonably believes, based on reasonable inquiry before the sale, that each and every purchaser has the capacity to evaluate the merits and risks of, and protect their own interests in, the franchise investment.

(c) Each and every purchaser of the franchise purchases the franchise for the purchaser's own account, or a trust account if the purchaser is a trustee, for the purpose of conducting the business as a franchise and not with a view to, or for a sale in connection with, any resale or distribution of the franchise or any interest in the franchise.

(d) The immediate cash payment required from a purchaser of the franchise who is a natural person, upon the purchase of the franchise, shall not exceed 10 percent of that person's net worth or joint net worth with that person's spouse, exclusive of that person's personal residence, any and all retirement or pension accounts or benefits, home furnishings and automobiles.

(e) The franchisor files with the commissioner a notice of exemption and pays the fee prescribed in subdivision (f) of Section 31500 prior to any offer or sale of a franchise in this state for which the exemption is claimed during any calendar year in which one or more franchises are sold, excluding any material modification.

(f) No franchisor or any of its officers, directors, employees, or agents shall form, organize, engage, or assist any person to purchase a franchise for resale or distribution to avoid the registration requirements of Chapter 2 (commencing with Section 31110).

SEC. 4. Section 31109.1 is added to the Corporations Code, to read:



31109.1. (a) There shall be exempted from the provisions of Chapter 2 (commencing with Section 31110) the offer and sale of a franchise registered under Section 31111, 31121, or 31123 on terms different from the terms of the offer registered thereunder if all of the following requirements are met:

(1) The initial offer is the offer registered under Section 31111, 31121, or 31123.

(2) The prospective franchisee receives all of the following in a separate written appendix to the offering circular:

(A) A summary description of each material negotiated term that was negotiated by the franchisor for a California franchise during the 12 month period ending in the calendar month immediately preceding the month in which the negotiated offer or sale is made under this section.

(B) A statement indicating that copies of the negotiated terms are available upon written request.

(C) The name, telephone number, and address of the representative of the franchisor to whom requests for a copy of the negotiated terms may be obtained.

(3) The franchisor certifies or declares in an appendix to its application for renewal that it has complied with all of the requirements of this section, in the event this exemption is claimed.

(4) The negotiated terms, on the whole, confer additional benefits on the franchisee.

(b) The franchisor shall provide a copy of the negotiated terms described in subdivision (a) to the prospective franchisee within five business days following the request of the franchisee.

(c) The franchisor shall maintain copies of all material negotiated terms for which this exemption is claimed for a period of five years from the effective date of the first agreement containing the relevant negotiated term. Upon the request of the commissioner, the franchisor shall make the copies available to the commissioner for review. For purposes of this section, the commissioner may prescribe by rule or order the format and content of the summary description of the negotiated terms required by subdivision subparagraph (A) of paragraph (2) of subdivision (a).

(d) For purposes of this section, “material” means that a reasonable franchisee would view the terms as important in negotiating the franchise.

SEC. 5. Section 31119 of the Corporations Code is amended to read:

31119. (a) It is unlawful to sell any franchise in this state which is subject to registration under this law without first providing to the prospective franchisee, at least 10 business days prior to the execution by the prospective franchisee of any binding franchise or other



agreement, or at least 10 business days prior to the receipt of any consideration, whichever occurs first, a copy of the offering circular, together with a copy of all proposed agreements relating to the sale of the franchise.

(b) Nothing in this division shall be construed to prevent a franchisor from providing copies of the offering circular documents to prospective franchisees through electronic means pursuant to any requirements or conditions that may be imposed by rule or order of the commissioner.

SEC. 6. Section 31125 of the Corporations Code is amended to read:

31125. (a) An application for registration of a material modification of an existing franchise or of existing franchises shall be in a form and contain information as the commissioner may by rule prescribe, and shall be accompanied by a proposed disclosure form as specified in subdivision (b). The application may be included with an application pursuant to Section 31111 or 31121.

(b) Except as provided in subdivisions (c) and (d), it is unlawful to solicit the agreement of a franchisee to a proposed material modification of an existing franchise without first delivering to the franchisee a written disclosure, in a form and containing information as the commissioner may by rule or order require, identifying the proposed modification, either five business days prior to the execution of any binding agreement by the franchisee to the modification or containing a statement that the franchisee may, by written notice mailed or delivered to the franchisor or a specified agent of the franchisor within not less than five business days following the execution of the agreement, rescind the agreement to the material modification.

(c) Any modification of a franchise agreement with an existing franchisee of a franchisor shall be exempted from the provisions of this chapter, if all of the following are met:

(1) The franchisee receives the complete written modification at least five business days prior to the execution of a binding agreement, or providing that the franchisee may, by written notice mailed or delivered to the franchisor or a specified agent of the franchisor within not less than five business days following the execution of the agreement, rescind the agreement to the material modification; provided (A) the agreement is not executed within 12 months after the date of the franchise agreement, and (B) the modification does not waive any right of the franchisee under the California Franchise Relations Act (Chapter 5.5 (commencing with Section 20000) of Division 8 of the Business and Professions Code), but the modification may include a general release of all known and unknown claims by a party to the modification.

(2) The modification meets one of the following:



(A) The proposed modification is in connection with the resolution of a bona fide dispute between the franchisor and the franchisee or the resolution of a claimed or actual franchisee or franchisor default, and the modification is not applied on a franchise systemwide basis at or about the time the modification is executed. A modification shall not be deemed to be made on a franchise systemwide basis if it is offered on a voluntary basis to fewer than 25 percent of the franchisor's California franchises within any 12-month period.

(B) The proposed modification is offered on a voluntary basis to fewer than 25 percent of the franchisor's California franchises within any 12-month period, provided each franchisee is given a right to rescind the modification agreement if the modification is not made in compliance with paragraph (1) of subdivision (c).

(d) Any modification of a franchise agreement with an existing franchise of a franchisee shall be exempted from this chapter if the modification is offered on a voluntary basis and does not substantially and adversely impact the franchisee's rights, benefits, privileges, duties, obligations, or responsibilities under the franchise agreement.

(e) For purposes of this section, "California franchise" means: (1) an existing franchise of a franchisee with any location in this state from which sales, leases, or other transactions between the franchised business and its customers are made or goods or services are distributed, or (2) an existing franchise of a franchisee that is a resident of this state and that owns, controls, or has an equity interest in the franchise.

(f) A franchisor shall not make modifications in consecutive years for the purpose of evading the 25 percent requirements set forth above.

SEC. 7. Section 31300 of the Corporations Code is amended to read:

31300. Any person who offers or sells a franchise in violation of Section 31101, 31110, 31119, 31200, or 31202, or in violation of any provision of this division that provides an exemption from the provisions of Chapter 2 (commencing with Section 31110) of Part 2 or any portions of Part 2, shall be liable to the franchisee or subfranchisor, who may sue for damages caused thereby, and if the violation is willful, the franchisee may also sue for rescission, unless, in the case of a violation of Section 31200 or 31202, the defendant proves that the plaintiff knew the facts concerning the untruth or omission, or that the defendant exercised reasonable care and did not know, or, if he or she had exercised reasonable care, would not have known, of the untruth or omission.

SEC. 8. Section 31402 of the Corporations Code is amended to read:

31402. If, in the opinion of the commissioner, the offer of any franchise is subject to registration under this law and it is being, or it has been, offered for sale without the offer first being registered, the



commissioner may order the franchisor or offeror of that franchise to desist and refrain from the further offer or sale of that franchise unless and until the offer has been duly registered under this law. If, after that order has been made, a request for a hearing is filed in writing within 60 days from the date of service of the order by the person to whom the order was directed, a hearing shall be held in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, and the commissioner shall have all of the powers granted under that chapter. Unless that hearing is commenced within 15 business days after the request is made (or the person affected consents to a later date), the order shall be deemed rescinded.

If that person fails to file a written request for a hearing within 60 days from the date of service of the order, the order shall be deemed a final order of the commissioner and shall not be subject to review by any court or agency, notwithstanding Section 31501.

SEC. 9. Section 31403 of the Corporations Code is amended to read:

31403. If, in the opinion of the commissioner, the offer of any franchise exempt from registration under this law is being or has been offered for sale without complying with Section 31201, or any other provision that provides an exemption from Chapter 2 (commencing with Section 31110) of Part 2, the commissioner may order the franchisor or offeror of the franchise to desist and refrain from the further offer or sale of the franchise unless and until the offer is made in compliance with this law. If, after that order has been made, a request for a hearing is filed in writing within 60 days from the date of service of the order by the person to whom the order was directed, a hearing shall be held in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code and the commissioner shall have all of the powers granted under that chapter. Unless that hearing is commenced within 15 business days after the request is made, or the person affected consents to a later date, the order shall be deemed rescinded.

If that person fails to file a written request for a hearing within 60 days from the date of service of the order, the order shall be deemed a final order of the commissioner and shall not be subject to review by any court or agency, notwithstanding Section 31501.

SEC. 10. Section 31405 of the Corporations Code is amended to read:

31405. (a) Any person who violates any provision of this law, or who violates any rule or order made under this law, shall be liable for a civil penalty not to exceed ten thousand dollars (\$10,000) for each violation, which shall be assessed and recovered in a civil action brought



in the name of the people of the State of California by the commissioner in any court of competent jurisdiction.

(b) As applied to the penalties for acts in violation of this division, the remedies provided by this section and by other sections of this division are not exclusive, and may be sought and employed in any combination to enforce the provisions of this division.

(c) No action shall be maintained to enforce any liability created under subdivision (a) unless brought before the expiration of four years after the act or transaction constituting the violation.

SEC. 11. Section 31406 is added to the Corporations Code, to read:

31406. (a) If, upon inspection or investigation, based upon a complaint or otherwise, the commissioner has cause to believe that a person is violating any provision of this division or any rule or order promulgated pursuant to this division, the commissioner may issue a citation to that person in writing describing with particularity the basis of the citation. Each citation may contain an order to desist and refrain and an assessment of an administrative penalty not to exceed two thousand five hundred dollars (\$2,500) per violation and shall contain reference to this section, including the provisions of subdivision (c). All penalties collected under this section shall be deposited in the State Corporations Fund.

(b) The sanctions authorized under this section shall be separate from, and in addition to, all other administrative, civil, or criminal remedies.

(c) If within 60 days from the receipt of the citation, the person cited fails to notify the commissioner that the person intends to request a hearing as described in subdivision (d), the citation shall be deemed final.

(d) Any hearing under this section shall be conducted in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code.

(e) After the exhaustion of the review procedures provided for in this section, the commissioner may apply to the appropriate superior court for a judgment in the amount of the administrative penalty and order compelling the cited person to comply with the order of the commissioner. The application shall include a certified copy of the final order of the commissioner and shall constitute a sufficient showing to warrant the issuance of the judgment and order.

SEC. 12. Section 31407 is added to the Corporations Code, to read:

31407. (a) If, after examination or investigation, the commissioner has reasonable grounds to believe that any person is conducting business in violation of any provision of this division or related rule or order binding upon it, the commissioner may, by written order addressed to the person, direct the discontinuance of the violation. The order shall be



effective immediately, but shall not become final except in accordance with subdivision (b).

(b) An order issued pursuant to this section shall not become final except after notice to the affected person of the commissioner's intention to make the order final and of the reasons for the finding. The commissioner shall also notify the person that upon receiving a request the matter shall be set for hearing to commence within 15 business days after receipt of the request. The person may consent to have the hearing commence at a later date. If no hearing is requested within 60 days after the mailing or service of the required notice, and none is ordered by the commissioner, the order may become final without a hearing and that person shall immediately discontinue the practices named in the order. If a hearing is requested or ordered it shall be held in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, and the commissioner shall have all of the powers granted under that chapter. If, upon the conclusion of the hearing, it appears to the commissioner that the person is violating any provision of this division or any related rule or order binding upon it, the commissioner shall make the order of discontinuance final and the person shall immediately discontinue the practices named in the order.

SEC. 13. Section 31408 is added to the Corporations Code, to read:

31408. (a) If the commissioner determines it is in the public interest, the commissioner may include in any administrative action brought under this division, including a stop order, a claim for ancillary relief, including, but not limited to, a claim for rescission, restitution or disgorgement or damages on behalf of the persons injured by the act or practice constituting the subject matter of the action, and the administrative law judge shall have jurisdiction to award additional relief. The person affected may be required to attend remedial education, as directed by the commissioner.

(b) In an administrative action brought under this part the commissioner is entitled to recover costs, which in the discretion of the administrative law judge may include any amount representing reasonable attorney's fees and investigative expenses for the services rendered, for deposit into the State Corporations Fund for the use of the Department of Corporations.

SEC. 14. Section 31410 of the Corporations Code is amended to read:

31410. Any person who willfully violates any provision of this law, or who willfully violates any rule or order under this law, shall upon conviction be fined not more than one hundred thousand dollars (\$100,000) or imprisoned in the state prison, or in a county jail for not more than one year, or be punished by both that fine and imprisonment;



but no person may be imprisoned for the violation of any rule or order if he or she proves that he or she had no knowledge of the rule or order.

SEC. 15. Section 31411 of the Corporations Code is amended to read:

31411. Any person who willfully employs, directly or indirectly, any device, scheme, or artifice to defraud in connection with the offer or sale of any franchise or willfully engages, directly or indirectly, in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the offer, purchase, or sale of any franchise shall upon conviction be fined not more than one hundred thousand dollars (\$100,000) or imprisoned in the state prison, or in a county jail for not more than one year, or be punished by both that fine and imprisonment.

SEC. 16. Section 22063 is added to the Financial Code, to read:

22063. (a) This division does not apply to a franchise loan made by a franchisor to a franchisee or a subfranchisor or by a subfranchisor to a franchisee.

(b) For purposes of this section:

(1) “Franchise” means “franchise,” as defined in Section 31005 of the Corporations Code.

(2) “Franchisee” means “franchisee,” as defined in Section 31006 of the Corporations Code.

(3) “Franchisor” means “franchisor,” as defined in Section 31007 of the Corporations Code.

(4) “Area franchise” means “area franchise,” as defined in Section 31008 of the Corporations Code.

(5) “Subfranchise” means “subfranchise,” as defined in Section 31008.5 of the Corporations Code.

(6) “Subfranchisor” means “subfranchisor,” as defined in Section 31009 of the Corporations Code.

(7) “Franchised business” means a business operated pursuant to a franchise or area franchise by a franchisee or pursuant to a franchise, area franchise or subfranchise by a subfranchisor.

(8) “Franchise loan” means a commercial loan, as defined in Section 22502, made by a franchisor to a current or prospective franchisee or subfranchisor or a commercial loan by a subfranchisor to a current or prospective franchisee for the acquisition, construction, operation, development, equipping, expansion, contraction, consolidation, merger, recapitalization, reorganization, or termination of a franchised business provided that the following conditions are satisfied:

(A) The franchisor or subfranchisor making the franchise loan shall comply with all applicable federal and state franchise disclosure and registration laws, regulations, rules and orders, including, but not

limited to, the California Franchise Investment Law (Division 5 (commencing with Section 31000) of Title 4 of the Corporations Code) and the Federal Trade Commission Franchise Rule: Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (Code of Federal Regulations, Title 16, Chapter 1, Subchapter D, Part 436 (16 CFR 436), as amended) in connection with the offer or sale of any franchise, area franchise, or subfranchise to which the franchise loan relates.

(B) The proceeds of the franchise loan are intended by the borrowing franchisee or subfranchisor for use primarily for other than personal, family, or household purposes.

(C) The loan, if secured, is secured solely by the assets of the franchised business to which the franchise loan relates. Property used by the borrower primarily for personal, family, or household purposes, including the borrower's personal residence, shall not be taken as security for the loan.

(D) The loan is subject to the implied covenant of good faith and fair dealing under Section 1655 of the Civil Code.

(E) The lender shall fully and clearly disclose to the borrower, at or before the time the loan is made, the rates of interest, charges, and costs of the loan.

(c) For purposes of subparagraph (B) of paragraph (8) of subdivision (b), a lending franchisor or subfranchisor may rely on any written statement of intended purposes by the borrowing franchisee or subfranchisor. The statement may be a separate statement signed by the borrowing franchisee or subfranchisor or may be contained in another document signed by the borrowing franchisee or subfranchisor. The lending franchisor or subfranchisor may not be required to ascertain that the proceeds of a franchise loan are used in accordance with the statement of intended purposes.

(d) Nothing in this section is intended to abrogate or diminish the application of any other laws that are designed to protect borrowers, including, but not limited to, laws pertaining to licensing, unfair competition, usury and conflicts of interest.

SEC. 17. The Legislature finds and declares that it is not necessary or appropriate in the public interest or for the protection of borrowers to regulate franchise loans made by franchisors to franchisees or subfranchisors or by subfranchisors to franchisees under the limited circumstances described in Section 16 of this act.

SEC. 18. No reimbursement is required by this act pursuant to Section 6 of Article XIII B of the California Constitution because the only costs that may be incurred by a local agency or school district will be incurred because this act creates a new crime or infraction, eliminates



a crime or infraction, or changes the penalty for a crime or infraction, within the meaning of Section 17556 of the Government Code, or changes the definition of a crime within the meaning of Section 6 of Article XIII B of the California Constitution.

SEC. 19. Sections 1 to 15, inclusive, of this act shall become operative January 1, 2005.

SEC. 20. This act is an urgency statute necessary for the immediate preservation of the public peace, health, or safety within the meaning of Article IV of the Constitution and shall go into immediate effect. The facts constituting the necessity are:

In order for the provisions of this act to take effect at the earliest possible time, it is necessary that this act take effect immediately.

